Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC 95-133

CC Docket No. 93-179

In the Matter of

Price Cap Regulation of
Local Exchange Carriers

Rate-of-Return Sharing
and Lower Formula Adjustment

REPORT AND ORDER

Adopted: March 30, 1995 **Released:** April 14, 1995

By the Commission:

TABLE OF CONTENTS

Topic		Paragraph No.
I.	Introduction	
	A. Summary	1-4
	B. Background	5-6
	C. Sharing and Low-end Adjustment Mechanisms	7-12
II.	NPRM, Comments, and Discussion	
	A. Add-back Adjustment	13-14
	1. NPRM Discussion of Add-back Adjustment	15-16
	2. Add-back Adjustment Discussion and Comments	
	a. An add-back adjustment to price cap revenues produces the same results that a refund under rate-of-return regulation produces	17-28
	b. Add-back is a necessary part of the sharing and low-end adjustment mechanisms	29-37
	c. Add-back is consistent with the efficiency incentives of price caps	38-41
	d. Add-back is necessary to enforce earnings restrictions	42-45
	e. Interest included in calculating sharing adjustments must be included in add-back	46-47
	f. Add-back is not a major change to the price cap plan	48-50
	B. Credit for Below-cap Pricing	

1. NPRM Discussion of Credit for Below-cap Pricing	51
2. Comments on Credit for Below-cap Pricing	52-53
3. Discussion of Credit for Below-cap Pricing	54-55
III. Concluding Matters	
A. Conclusion	56
B. Regulatory Flexibility Act Analysis	57
C. Ordering Clauses	58-60
Appendix A	
Appendix B	

I. INTRODUCTION

A. Summary

1. Under the Commission's current system of price cap regulation, local exchange carriers (LECs) whose interstate earnings in a calendar year exceed specified benchmarks are required to share with ratepayers part or all of the earnings above the benchmarks. This sharing is accomplished through a one-time (non-permanent) reduction in their price cap indices at the next annual access tariff filing. The current price cap rules also permit LECs whose earnings fall below a specified low-end benchmark during a calendar year to make a (non-permanent) one-time upward adjustment to their price cap indices at the next annual filing. The upward adjustment is intended to permit the LEC to raise its interstate rates to levels that will enable the LEC to increase its interstate earnings to the low-end benchmark. These mechanisms are known as sharing and low-end adjustments. In this order, we consider revisions to our price cap rules to specify the manner in which these adjustments should be treated by the LECs in computing their interstate earnings for the year in which the sharing or low-end adjustment is effected.

2. The Commission previously adopted a refund mechanism for LECs subject to rate-of-return regulation. Under that scheme, LECs were required to refund earnings that exceeded the prescribed maximum allowable rate of return, plus a buffer, through rate reductions in a subsequent tariff filing period. LECs subject to rate-of-return regulation were required to treat those refund payments as adjustments to earnings for the period in which the overearnings occurred, known as the enforcement period, rather than to the period in which the refund is paid.[1] These LECs therefore were required to "add back" the amount of FCC-ordered refunds relating to the previous enforcement period into the total earnings used to compute the rate of return for

---

[1] Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements, 1 FCC Rcd 952, 956-57 (1986) (Rate of Return Procedures). The rate-of-return monitoring report filed by LECs that are not subject to price cap regulation, FCC Form 492, includes a line to record the amount of the refund. Id. at 960-61, Appendix C.

the current new enforcement period.[2] The refund thus has the same effect on earnings measurement that it would have if the LEC wrote a check for the amount of the overearnings on the last day of the enforcement period during which the overearnings occurred.

3. A brief example illustrates how an add-back adjustment under price caps works. Suppose a LEC earned $400 million from its interstate operations in 1994, with $100 million of that amount subject to a 50 percent sharing obligation. Pursuant to our rules, the LEC would be required to flow back $50 million to its ratepayers in 1995. If the LEC replicates its 1994 performance in 1995 by earning $350 million (i.e., $400 million minus the $50 million sharing adjustment), should it be allowed to say that it must only share half of $50 million in the next tariff year, not $100 million, because it refunded $50 million to consumers in 1995 due to its 1994 performance? It is clear that under our reporting rules for carriers subject to rate-of-return regulation, the answer is "no"; in this order, we conclude that the answer is also "no" prospectively for companies subject to price cap regulation.

4. For the reasons set forth below, we conclude that we should amend our rules to include an express requirement that price cap LECs make an analogous "add-back" adjustment to their interstate revenues when calculating earnings used to determine sharing and low-end adjustments for a year that follows a year in which a LEC incurred a sharing obligation or made a low-end adjustment.[3] Accordingly, we adopt the rule proposed in our Notice of Proposed Rulemaking to incorporate explicitly the "add-back" requirement into our price cap rules.[4]

B. Background

5. On September 19, 1990, the Commission replaced rate-of-return regulation with an incentive-based system of regulation, known as price caps, for the nation's largest local

---

[2] Section 65.600 of the Commission's Rules, 47 C.F.R. § 65.600. The net rate of return after a carrier adds back these amounts determines compliance with the prescribed rate of return during the new enforcement period and the amount of any refund obligation. Section 65.700-03 of the Commission's Rules, 47 C.F.R. § 65.700-03; see also Rate of Return Procedures, 1 FCC Rcd at 956 (The Commission stated that the add-back adjustment "should provide a clear picture of current earnings for the reporting period.").

[3] We do not decide in this rulemaking whether an add-back adjustment is required for purposes of the 1993 and 1994 Annual Access Tariff Filings. That issue is under examination as part of our investigation of the 1993 and 1994 Annual Access Tariff Filings. See 1993 Annual Access Tariff Filings, CC Docket No. 93-193, 8 FCC Rcd 4960 (Com. Car. Bur. 1993); see also 1994 Annual Access Tariff Filings, CC Docket No. 94-65, 9 FCC Rcd 3519 (Com. Car. Bur. 1994).

[4] Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, 8 FCC Rcd 4415, Appendix B (1993) (NPRM).

exchange carriers.[5] In designing the LEC price cap plan, the Commission's objective was to harness the profit-making incentives common to all businesses in order to advance the public interest goals of just, reasonable, and non-discriminatory rates, as well as a communications system that offers innovative, high quality services.[6]

6. Under the LEC price cap plan, a carrier's interstate services are grouped within baskets. Each basket is subject to a price cap index (PCI) that is designed to limit the prices carriers charge for service.[7] The PCI is adjusted annually to account for three factors. The first is a measure of inflation -- the Gross National Product - Price Index (GNP-PI). The second, a 3.3 percent offset, captures the amount by which annual LEC efficiency gains have historically exceeded efficiency gains achieved in the economy as a whole, as measured by the GNP-PI. In lieu of the base 3.3 percent offset, a LEC may elect the more challenging 4.3 percent offset. LECs that can outperform the offset that they select are rewarded with the ability to retain reasonably higher earnings than would be allowed under the former cost-of-service regulatory system.[8] The third element allows the value of the PCI to move up or down in response to specific exogenous cost changes. The cap generally is calculated once a year, for LEC tariffs that become effective on July 1.[9]

C. Sharing and Low-end Adjustment Mechanisms

7. Recognizing that the uniform base 3.3 percent productivity factor might not be an accurate measure of productivity for all LECs, the Commission adopted the sharing and low-end adjustment mechanisms that are based on a carriers's earned rate of return.[10] The

---

[5] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) (LEC Price Cap Order), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), modified on recon., 6 FCC Rcd 2637 (1991) (LEC Price Cap Reconsideration Order), aff'd sub nom., National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993) (LEC Price Cap Orders). Specifically, the LEC price cap system is mandatory for the seven Regional Bell Operating Companies Commission and GTE. It is optional for other LECs.

[6] LEC Price Cap Order, 5 FCC Rcd at 6787.

[7] Id.

[8] LEC Price Cap Order, 5 FCC Rcd at 6792.

[9] Id.

[10] The Commission stated that "individual LECs may experience significant variations from the industry productivity norm . . . as a result of regional economic booms or recessions, among other factors." Id. at 6801. The Commission determined that "[t]hese possible sources of errors in the productivity offset support the adoption of [sharing and low-end adjustment mechanisms]." Id.

Commission designed the sharing and low-end adjustment mechanisms to ensure that LECs and their customers share fairly the risks and rewards of future productivity gains. Noting that LEC price cap regulation is intended to produce rates of return within a "zone of reasonableness," the Commission stated that under the sharing mechanism, LEC earnings in excess of a specified return would be shared with, or returned to ratepayers.[11] Similarly, if a LEC's earnings fell below a specified floor, the low-end adjustment mechanism permits the LEC to raise its PCI so that it may raise its rates to target the specified floor rate of return. The Commission stated that the low-end adjustment mechanism was intended to prevent any price cap LEC from experiencing such low earnings over an extended period of time that its ability to provide quality service and attract capital at reasonable rates would be seriously impaired.[12]

8. Under the sharing mechanism, a LEC that selects and outperforms the 3.3 percent productivity offset is entitled to retain all of its earnings up to 1 percent above the 11.25 percent earnings threshold[13] (i.e., 12.25 percent).[14] A LEC using the 3.3 percent productivity offset must share with its customers half of its earnings between 12.25 percent and 16.25 percent, and all of its earnings in excess of 16.25 percent.[15] The sharing mechanism effectively allows a LEC selecting a 3.3 percent productivity offset to reach a maximum 14.25 percent rate of return.[16] Alternatively, a LEC selecting the higher 4.3 percent productivity offset may retain all of its earnings up to 13.25 percent and half of all higher earnings up to 17.25 percent. All earnings that exceed 17.25 percent must be returned to ratepayers. By electing a productivity offset of 4.3 percent, a LEC can realize a 15.25 percent rate of return.[17] The customers' share is returned with interest through a one-time reduction in the PCI for the next annual access period, calculated

---

[11] Id. at 6787.

[12] Id. at 6787, 6801, 6802; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2677.

[13] The initial 11.25 percent level corresponded to the rate of return established for rate of return carriers in Represcribing the Authorized Rate of Return for Interstate Service of Local Exchange Carriers, 5 FCC Rcd 7507 (1990) (Represcription Order). See LEC Price Cap Order, 5 FCC Rcd at 6788, 6802.

[14] LEC Price Cap Order, 5 FCC Rcd at 6788.

[15] Id. at 6801.

[16] Id.

[17] Id. at 6788, 6801-02; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2652; see generally LEC Price Cap Order, 5 FCC Rcd at 6803 ("The additional profit incentive created for LECs that elect a 4.3 percent productivity incentive will have a permanent effect on the LEC, because the higher factor will be reflected in the LEC's PCI in future years.").

in the same manner as other exogenous changes in the formula.[18] The Commission stated that the sharing mechanism would "operate[] only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings . . . ."[19]

9. Under the low-end adjustment mechanism, if the earnings of a LEC fall below 10.25 percent in a base year, the LEC may raise its PCI, and consequently its rates, in the following year to target earnings at 10.25 percent, using the base period to compute the amount of the adjustment to the PCI.[20] The low-end adjustment mechanism operates as a one-time adjustment to a single year's rates, "in keeping with the one-year adjustments made to effect sharing."[21]

10. The first application of the sharing and low-end adjustment mechanisms occurred in the 1992 annual access tariff filings. LECs with earnings levels in the 1991 calendar year above 12.25 percent lowered their price cap indexes by a total of $76.8 million in 1992 because of the sharing requirement, while LECs with earnings below 10.25 percent in 1991 increased their indexes by a total of $96.6 million in 1992 because of the low-end adjustment mechanism. The 1993 annual access tariff filings required the Commission to determine how the sharing and low-end adjustments to the price cap indexes in 1992 should be reflected in the LECs' 1992 earnings figures used to determine necessary sharing and permitted low-end adjustments for tariff year 1993-94.

11. Some of the price cap LECs proposed that the earnings levels used to compute sharing and low-end adjustments to be implemented in 1993 should include the effects of the sharing and low-end adjustments for 1992, without the add-back adjustment. This would reduce

---

[18] LEC Price Cap Order, 5 FCC Rcd at 6801; see also id. at 6788; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2686. The shared amounts are calculated on the basis of total interstate earnings. LEC Price Cap Order, 5 FCC Rcd at 6805; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2680.

[19] LEC Price Cap Order, 5 FCC Rcd at 6803; see also id. at 6788 (in adopting the sharing mechanism, the Commission decided not to adopt the previously considered "automatic upper stabilizer" device because it "would have created permanent downward adjustments to the cap each time earnings rose above a specified level") (emphasis added); id. at 6802 ("[The upper stabilizer device] would have required an automatic adjustment in a particular LEC's PCI if that LEC achieved a rate of return for an annual price cap period that differed from the target rate of return prescribed for LECs that are not subject to price caps by more than 2 percent").

[20] Id. at 6788; see also id. ("Should a LEC's earnings drop below . . . [10.25 percent], that LEC is entitled to a prospective automatic upward adjustment to its cap."); see also id. at 6802 ("We . . . set the lower adjustment mark at 10.25 percent, to be symmetrical with the 12.25 percent top of the no sharing zone.").

[21] LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2691 n.166.

sharing amounts in 1993 for LECs who were also subject to sharing in 1992. Other LECs proposed to adjust their earnings to include the amount associated with the add-back adjustment. This approach would allow higher rates in 1993 for LECs that had received a low-end adjustment in 1992.

12. To address this and other issues raised by the 1993 annual access rates filings, the Commission suspended rates filed by price cap LECs for one day, issued an accounting order, and initiated an investigation.[22] That investigation is examining how under the existing price cap rules the sharing and low-end adjustments made to 1993 rates because of earnings in the 1992 access year should be reflected in the rate of return used to determine the 1994 sharing and low-end adjustments. The general issue of add-back adjustments, however, was the subject of the NPRM adopted in this proceeding shortly before those tariffs took effect.

II. NPRM, COMMENTS, AND DISCUSSION

A. Add-back Adjustment

13. We use the term "add-back adjustment" to describe the process that eliminates the effects of sharing or low-end adjustments required by the prior year's earnings on the current year's earnings. The process requires a price cap LEC to add an amount equal to the sharing adjustment amount to its current year revenues before calculating a LEC's rate of return for the current year. If a low-end adjustment was made in the prior year, the amount of the adjustment is subtracted from the current year's revenues before computing earnings for the current year. The current year's earnings, thus adjusted, determine whether sharing is required, or a low-end adjustment is permitted, in the next tariff year.

14. In general, adding an amount equal to the sharing adjustment to the earnings calculation increases a LEC's earnings level for purposes of determining its sharing and lower-end adjustments in the following year. By excluding low-end adjustment amounts from the earnings calculation, the LECs' earnings level used to compute the following year's sharing and low-end adjustments would generally be lowered to the level that earnings would have reached if there had been no low-end adjustment.

1. NPRM Discussion of Add-back Adjustment

15. On June 18, 1993, the Commission adopted a Notice of Proposed Rulemaking requesting comment on our tentative conclusion that the price cap LECs should continue to be required to "add back" sharing and low-end adjustments when calculating their rates of return in the year following those adjustments, and that the price cap rules should be amended to include

[22] See 1993 Annual Access Tariff Filings, 8 FCC Rcd 4960 (Com. Car. Bur. 1993); see also 1994 Annual Access Tariff Filings, 9 FCC Rcd 3519 (Com. Car. Bur. 1994).

explicitly the add-back requirement.[23] In the NPRM, we said that, while we "believe[d] that 'add-back' is more consistent with the price cap plan as it was adopted, we recognize[d] that this issue was neither expressly discussed in the LEC price cap orders nor clearly addressed in our Rules." We, therefore, proposed to amend the price cap rules to incorporate the "add-back" requirement.[24] We proposed specific language to clarify our rules and implement our tentative conclusion.[25] We also requested comment on whether a LEC that has set its rates below the price cap indexes during the base year should receive credit for the difference between its PCI and its actual price index (API) in calculating sharing and low-end adjustment amounts.[26]

16. We find that the add-back adjustment is a necessary element of the sharing and low-end adjustment mechanisms. Therefore, we adopt a rule explicitly incorporating the add-back process into the LEC price cap plan. In addition, we decide that our rules should not be modified to provide LECs with credit for below-cap rates in calculating sharing and low-end adjustment amounts.

2. Add-back Adjustment Discussion and Comments

a. An add-back adjustment to price cap revenues produces the same results that a refund under rate-of-return regulation produces.

17. As summarized above, under rate-of-return regulation, a refund of overearnings would be treated as if it were paid on the last day of the period in which the overearnings occurred, notwithstanding that the refund is actually paid out during the succeeding enforcement period. Consequently, the refund amount is added to a carrier's revenues for purposes of computing its earnings during the period in which the refund actually was paid. Under the LEC price cap system of regulation, we have designed our sharing and low-end adjustment mechanisms around benchmark earning levels. The Commission emphasized in the LEC Price Cap Order that the sharing and low-end adjustment mechanisms are intended to be one-time

---

[23] NPRM, 8 FCC Rcd at 4417; see also id. ("[W]e tentatively conclude that the add-back adjustment should continue to be part of the rate of return calculations of LECs subject to price caps").

[24] Id. at 4415; see also id. at 4416 (The NPRM stated that "add-back appears necessary to the rate of return thresholds applied to determine price cap LECs' sharing obligations and lower adjustments right[s] . . . .").

[25] See id. at Appendix B (the Commission proposed revising Section 61.3(e) of the Commission's Rules, 47 C.F.R. § 61.3(e), which defines the term "Base Period," to add that "[b]ase year or base period earnings shall not include amounts associated with exogenous adjustments to the PCI for the sharing or lower formula adjustment mechanisms.").

[26] Id. at 4417.

adjustments to a carrier's earnings, in the same way that the refund mechanism operates under rate-of-return regulation.[27]

18. The following example illustrates the effects of an add-back adjustment under our current price cap rules and shows that the adjustment is a necessary component of the sharing adjustment mechanism. The example examines the effects of different regulatory requirements on a company that in the base year has revenues of $2425, expenses of $1000, and a rate base of $10,000. Therefore, the company's base year return (i.e., revenues minus expenses) is $1425 ($2425 minus $1000). The company's rate of return (ROR) (i.e., return divided by rate base) is 14.25 percent ($1425 divided by $10,000).

19. Assume first that a company under rate-of-return regulation is required to refund earnings above a 13.25 percent rate of return, measured on a calendar year basis and that the company earns 14.25 percent in year 1. Assume further that the company makes its refunds through a refund check that is issued on the last day of year 1 rather than by reducing its rates in the coming year. The following chart shows the effects of the refund requirement on the company in years 1 through 4, assuming constant revenues, expenses and rate base.

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,425	2,425	2,425
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	14.25	14.25	14.25
Refund	100	100	100	100
ROR (net of regulation)	13.25	13.25	13.25	13.25

As this example shows, because the company refunds the money owed at the end of the year in which the liability is incurred, no adjustment is necessary to its revenues in the following year.

[27] LEC Price Cap Order, 5 FCC Rcd at 6803 (sharing and low-end adjustments should "operate[] only as . . . one-time adjustment[s] to a single year's rates, so a LEC . . . [does] not risk affecting future earnings"); LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2691 n.166.

20. Assume now that the same company is instead subject to a sharing obligation with an add-back requirement. Assume further that the company is required to share 50 percent of its earnings above a 12.25 percent rate of return. The following chart shows the effect of the add-back requirement on the company in years 1 through 4, again assuming constant revenues, expenses and rate base.

Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,325	2,325
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
Add-back	0	100	100	100
ROR with Add-back	14.25	14.25	14.25	14.25
Sharing	100	100	100	100
ROR (net of regulation)	14.25	13.25	13.25	13.25

By including an add-back adjustment to its earnings in Year 2 and thereafter, the company has the same rate of return and returns the same amount of money to ratepayers as the rate-of-return regulated company that makes its refund by a check. The add-back adjustment measures the company's performance in year 2 and each subsequent year after eliminating the effect of its performance in the prior year from the calculation of the current year's earnings.

21. Contrast the foregoing results with those that occur if the same company is subject to a sharing obligation, but without an add-back requirement.

No Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,375	2,350
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	13.25	13.75	13.50
Sharing to be returned in next year	100	50	75	62.50

Under this scenario, the company shares fewer revenues than it would under the rate-of-return or add-back scenarios and earns a different rate of return each year, even though its financial performance and underlying costs did not change.

22. The foregoing examples show that adding back an amount equal to the sharing adjustment ensures that the earnings thresholds applied to determine price cap LECs' sharing obligations are those we intended when we adopted these mechanisms. In the example presented above, the add-back requirement ensures that a price cap carrier incurs the same sharing obligation ($100) in year 2 as a carrier that paid a refund on the last day of the year in which the obligation was incurred. Without an add-back requirement, the price cap carrier would share a lower amount ($50) of its earnings from year 2, because the carrier would reduce its earnings in year 2 by the amount of the sharing obligation incurred in the prior year. That result would permit LECs to avoid or reduce their sharing obligations in year 2 if their unadjusted rate of return exceeded the sharing benchmarks established by our price cap rules.

23. It bears emphasis that a sharing adjustment under price caps operates very much like a refund under rate-of-return regulation in that the obligation arises because of the previous year's high earnings. Further, both the sharing adjustment and the refund occur in the year after the year in which the high earnings were realized. In both cases, ignoring the effects of a sharing adjustment will make a LEC's earnings, and therefore its productivity, appear to be lower than it actually is during the year in which the sharing amount is flowed through to ratepayers.

24. A comparison of three scenarios involving a low-end adjustment similarly shows that an add-back adjustment is necessary to produce the results that we intended for price cap

companies. These scenarios assume a company that has revenues of $1925, expenses of $1000 and a rate base of $10,000.

25. Assume first that the company receives its low-end adjustment through a check issued to it on the last day of the year in which the low earnings occur.

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	1,925	1,925	1,925
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	9.25	9.25	9.25
LowEnd Adj	100	100	100	100
ROR with Adj	10.25	10.25	10.25	10.25

26. Now assume that the same company is instead subject to a low-end adjustment mechanism with an add-back requirement.

Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	2,025	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	10.25	10.25	10.25
Add-back	0	-100	-100	-100
LowEnd Adj	100	100	100	100
ROR with Add-back	9.25	9.25	9.25	9.25

As in the sharing example, the company that makes an add-back adjustment to its revenues in the second year to account for the low-end adjustment incurred in the first year has the same rate of return and receives the same amount of money as the company under rate-of-return regulation that receives its low-end adjustment through a check issued at the end of year 1.

27. Contrast those results with the effect of a low-end adjustment mechanism without an add-back adjustment on the same company.

No Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	1,925	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	10.25	9.25	10.25
LowEnd Adj to be re-gained in next year	100	0	100	0

Under this approach, the company receives less revenues for the low-end adjustment than it would under the two other approaches illustrated above and would report a different rate of return each year, even though its financial performance and underlying costs did not change.

28. Without an add-back adjustment, LECs that make low-end adjustments because of prior years' low earnings would be entitled to smaller adjustments if their current year's earnings fell below the low end of the range. As our example shows, ignoring the amount ($100) paid to the carrier as a low-end adjustment for the prior year would inflate the carrier's earnings in year 2. Over time, effective earnings could fall below or above the benchmark levels that we established as an integral part of our initial price cap regulatory regime. For example, the LECs' unadjusted 1993 rates of return used to compute 1994 sharing and lower- end adjustments would on average be 0.2 percent higher at the upper end, and 0.5 percent lower at the low end than if adjusted. The add-back adjustment, however, corrects these deviations and ensures that the LECs' earnings fall within the range we selected in the LEC Price Cap Order.

b. Add-back is a necessary part of the sharing and low-end adjustment mechanisms.

29. NYNEX and AT&T agree with the Commission's tentative conclusion that price cap LECs should be required to include sharing and low-end adjustment amounts when calculating their earnings for the subsequent year.[28] Also, NYNEX contends that the inclusion

[28] NYNEX Reply Comments at 2; AT&T Comments at 1-2.

of these amounts is necessary to ensure that sharing and low-end adjustments operate as one-time adjustments.[29] NYNEX asserts that failure to offset the effect of sharing and low-end adjustment revenues would undermine the earnings ranges in the sharing and low-end adjustment mechanisms.[30]

30. SNET concurs with the Commission that an offset equal to any low-end adjustment add-back is necessary to maintain the proper relationship between earnings levels and performance in a prior year, and argues that without this adjustment, artificial swings in earnings can occur.[31] MCI claims that sharing amounts "must be added back in order to properly calculate rates of return . . . ."[32]

31. Other commenters, however, disagree in whole or in part with the Commission's tentative conclusion. Some of the commenters claim that the Commission intended price caps to be a departure from rate-of-return regulation.[33] They contend that a refund under rate-of-return regulation cannot be analogized to a sharing obligation under price caps because the former is a product of overearnings and is based on a finding that rates are unlawfully high, whereas the latter is the result of lawful earnings within the sharing zones.[34]

32. One of the basic elements of the current price cap plan for LECs is the requirement that carriers share with ratepayers efficiency gains that exceed the benchmarks established in the LEC Price Cap Order.[35] As already noted, the Commission chose rate-of-return as the measure for determining when annual efficiency gains warranted sharing. The Commission even centered the earnings thresholds that triggered sharing and low-end adjustments on the 11.25 percent rate of return prescribed for LECs subject to rate-of-return regulation. We also noted above that the sharing mechanism serves the same function under price cap regulation

---

[29] NYNEX Reply Comments at 14-15.

[30] Id. at 5.

[31] SNET Comments at 1-3. SNET does not address whether a sharing add-back should be required under the LEC price cap plan.

[32] MCI Comments at 6.

[33] See Ameritech Comments at 2; see also Bell Atlantic Comments at 5; GTE Comments at 3, 9; Pacific Comments at 1-2; RTC Comments at 2; US West Comments at 4.

[34] Pacific Comments at 2; see also RTC Comments at 2; Ameritech Comments at 2; US West Comments at 4; GTE Comments at 10; BellSouth Reply Comments at 11; Bell Atlantic Reply Comments at 4.

[35] See LEC Price Cap Order, 5 FCC Rcd at 6801; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2676-77.

that a refund mechanism performs under rate-of-return regulation. That is, both mechanisms are designed to return to ratepayers in year 2 a portion of the carrier's earnings from the prior year. Accordingly, we find that the policies and rules governing the calculation of refunds under rate-of-return regulation are relevant by analogy to the calculation of those earnings thresholds. We also find that an add-back requirement is not only fully consistent with, but also an essential element of, the system of price cap regulation that we adopted for LECs in 1990. We note, moreover, that in adopting the LEC Price Cap Order, the Commission did not state that it intended to eliminate the requirement under rate-of-return regulation that carriers subtract revenues reflecting out-of-period earnings for purposes of calculating current year earnings.

33. Several commenters argue that requiring LECs to make an add-back adjustment would cause a single year's rate-of-return adjustment to have an impact on sharing requirements and low-end adjustment rights in future years, a result which they contend is inconsistent with the Commission's intention that sharing and low-end adjustment mechanisms operate as one-time adjustments.[36] Bell Atlantic and Ameritech claim that a company that would otherwise not be sharing based on its "actual" earnings during a base year (i.e., earnings without add-back) could be required to share in the subsequent year based solely on the add-back adjustment.[37] In addition, Bell Atlantic argues that an add-back adjustment effectively operates like the automatic stabilizer rejected by the Commission when it adopted LEC price caps.[38]

34. Contrary to the commenters' contention, an add-back adjustment, by removing the effects of sharing and low-end adjustments associated with the previous year's earnings, ensures

---

[36] See Bell Atlantic Comments at 2 n.5; see also Ameritech Comments at 6; GTE Comments at 7; Pacific Comments at 4; US West Comments at 2.

In support of its claim that add-back adjustments "can cause a single year's sharing to impact a company year after year[,]" Bell Atlantic provides the example of a LEC that earns total revenues of $2,616 million in the base year and, as a result of a sharing adjustment, earns total revenues of $2,590 million in the second year. Bell Atlantic Comments at 2-3 and Workpapers 1-1 and 1-2. In Bell Atlantic's hypothetical, the LEC maintains its API equal to its PCI, generates total revenues of $2,590 million in the third and subsequent years and earns a rate of return of 12.25 percent without an add-back adjustment. Bell Atlantic's hypothetical, which takes into account taxes and interest, indicates that if the LEC were subject to an add-back requirement, it would incur sharing obligations equal to $23 million in the base year, and $7 million, $9 million, $5 million, and $3 million, for the second, third, fourth, and fifth years. Bell Atlantic contends that the add-back requirement causes the LEC to incur sharing obligations in the third year and each year thereafter, despite the fact that the LEC's unadjusted earnings in those years would not trigger a sharing obligation. Bell Atlantic claims that the LEC's sharing obligation in the third and subsequent years is caused by the initial add-back calculation in the second year.

[37] Bell Atlantic Comments at 2; Ameritech Comments at 6.

[38] Bell Atlantic Reply Comments at 4; see also supra fn. 19.

that these adjustments function as "one-time adjustment[s] to a single year's rates."[39] An add-back adjustment therefore ensures that the sharing and low-end adjustment mechanisms operate as intended. Contrary to the claims of Bell Atlantic and Ameritech, computation of a LEC's sharing obligation and low-end rights in a current year based upon actual, unadjusted earnings (i.e., without the add-back adjustment) would cause the prior year's sharing and low-end adjustments to be reflected in the LEC's current earnings levels. Consequently, instead of affecting a LEC's earnings for only one year, as contemplated by our price cap rules, the sharing and low-end adjustment would affect its earnings, and possibly its sharing obligations and/or low-end adjustment rights, in future years as well. For example, assume that a LEC experiences a substantial, one-time efficiency gain in year 1 so that its earnings significantly exceed the benchmarks. Assume further that the same carrier achieves much more modest efficiency gains in the next year. If the LEC's earnings in the second year are not adjusted to remove the effects of a sharing adjustment, its unadjusted earnings could fall below the low-end benchmark. In that event, the carrier would be entitled to make an upward adjustment to its indices, and consequently its rates, in the third year solely because of its sharing obligation in the second year.

35. The fact that a company that would otherwise not be sharing based on its unadjusted earnings could be required to share as a result of the adjustment does not demonstrate that requiring the add-back adjustment is unreasonable. Bell Atlantic mischaracterizes the cause of the sharing in these circumstances. Sharing does not arise because of an add-back adjustment, but rather because the LEC's earning levels in each year, once adjusted to remove the effects of a sharing obligation generated by a previous year's high earnings, remain in the sharing zone. Bell Atlantic's argument ignores our expressed intent that the sharing mechanism act as a one-time adjustment to a previous year's high earnings. We adopt the add-back mechanism precisely to ensure that the effect of a one-time sharing or low-end adjustment does not have a ripple effect from year to year. Bell Atlantic's view, if adopted, would enable a LEC to reduce any further sharing obligations by implementing the sharing obligation created by the first year's high earnings. This is contrary to our expressed intent that the sharing mechanism operate as a one-time adjustment to a single year's rates, and we decline to accept it here. Bell Atlantic's related argument concerning the automatic upper-end stabilizer mechanism confuses that mechanism, which the Commission rejected in the price cap rulemaking proceeding, with the sharing adjustment mechanism. Simply stated, the stabilizer would have resulted in a "permanent" downward adjustment to a LEC's PCI,[40] whereas the sharing adjustment was intended to operate as a one-time adjustment to a LEC's PCI. The add-back adjustment ensures that the sharing mechanism and the low-end adjustment mechanism operate as the Commission intended.

---

[39] LEC Price Cap Order, 5 FCC Rcd at 6803; LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2691 n.166.

[40] See LEC Price Cap Order, 5 FCC Rcd at 6788 ("[I]n adopting the one-time sharing adjustment mechanism, the Commission considered and rejected an 'automatic upper stabilizer' that] would have created permanent downward adjustments to the cap each time earnings rose above a specified level") (emphasis added); see also id. at 6803.

36. MCI argues that an adjustment to offset a low-end adjustment in a prior year should not be allowed because this kind of adjustment does not apply to rate increases under rate-of-return regulation.[41] MCI, BellSouth, and Bell Atlantic contend that an adjustment to offset a low-end adjustment would guarantee that price cap LECs earn a minimum 10.25 percent rate of return, a guarantee that they maintain does not exist under rate-of-return regulation and was rejected in the LEC Price Cap Reconsideration Order.[42] In addition, MCI asserts that with a low-end adjustment add-back, revenues attributable to low-end adjustment rate increases would never be included in the calculation of base period earnings.[43]

37. These arguments raised by MCI, BellSouth, and Bell Atlantic relating to the low-end adjustment mechanism misapprehend how the add-back adjustment operates in a case in which a LEC in the prior year was permitted to increase its PCI to the level required to earn 10.25 percent. In calculating the current year's earnings, the LECs would be required to exclude the revenue effects of that upward PCI adjustment. Contrary to the claims of MCI, BellSouth and Bell Atlantic, the add-back adjustment does not guarantee that a LEC will earn 10.25 percent or any other particular rate of return in the current year. Assume, for example, that a carrier is permitted a low-end adjustment of $100 in year 2 to offset an equivalent shortfall below the benchmark low-end adjustment level in year 1. Assume further that in year 2 revenues remain constant, but costs increase by $100. In that event, a carrier's earnings in year 2 will fall below the low-end adjustment benchmark. In short, even with the add-back adjustment, a LEC's earnings may be equal to, greater or less than 10.25 percent. The add-back adjustment, however, does ensure that the low-end adjustment in the prior year operates only as a one-time adjustment to a LEC's PCI.

c. Add-back is consistent with the efficiency incentives of price caps.

---

[41] MCI Comments at 11-12. Stating that MCI's bifurcated position on the add-back adjustment coincides with MCI's financial interests, several commenters argue that both the sharing and low-end adjustment mechanisms were intended to compensate for unanticipated errors in the productivity offset and must be treated identically. GTE Reply Comments at 11; BellSouth Reply Comments at 12; Ameritech Reply Comments at 3; Bell Atlantic Reply Comments at 4.

[42] MCI Comments at 3, 12-14; BellSouth Reply Comments at 8; Bell Atlantic Comments at 3-4. Bell Atlantic asserts that the add-back procedure causes a single year's low-end adjustment to "provid[e] a multi-year compounded benefit . . . produc[ing] a guaranteed return of almost 10 percent without any productivity gain." Id. In support, Bell Atlantic submits workpapers allegedly comparing and contrasting the effects of a low-end adjustment. See Bell Atlantic Comments, Workpapers 1-3 and 1-4. These comparisons are flawed because, as NYNEX points out, Bell Atlantic includes different productivity changes in Workpaper 1-4 to produce the same underlying rates of return as in Workpaper 1-3. Therefore, these examples do not support Bell Atlantic's assertion.

[43] MCI Comments at 3, 6-9.

38. US West contends that because add-back adjustments would "perversely" affect LECs that price below their PCIs, these adjustments would discourage LECs from doing so, a result contrary to the concept of incentive-based price cap regulation.[44] US West provides an example in which a LEC sets its API 10 percent below its PCI and incurs a sharing obligation in year one. In subsequent years, the LEC continues to price below its PCI and to incur sharing obligations. US West's example suggests that by including the shared amounts in calculating earnings in the next year, the LEC's adjusted rate of return and sharing amounts will continue to increase even though operational results do not change. US West asserts that eventually, the LEC's API will equal its PCI. At that point, US West argues, the LEC will be forced to reduce prices by a "disproportionate amount" in the next tariff year.[45]

39. The hypothetical example submitted by US West presents an unrealistic pricing and sharing fact pattern and, consequently, does not persuade us that add-back adjustments undercut the efficiency incentives of LEC price caps. US West submits no evidence to support its assumption that carriers that price substantially below their PCIs will incur sharing obligations. In addition, US West submits no evidence supporting the reasonableness of its assumption that carriers would continue to price below their caps and incur sharing obligations over a sustained period of time. We believe that in the unlikely situation a carrier intended to price as far below its PCI, as the US West example suggests, the LEC likely would select 4.3 percent as its productivity factor because the higher productivity factor would enable the LEC to retain a greater share of its earnings. If LECs over a sustained period of time were not only pricing below their PCIs, but also incurring sharing obligations (as in US West's example), those circumstances may indicate that our base productivity factor is too low, but does not demonstrate that add-back adjustments are inconsistent with our system of price cap regulation. The issues of whether the productivity factor selected in the LEC Price Cap Order should be revised, and whether the current 3.3 percent base factor is incorrect are being addressed as part of the LEC price cap performance review proceeding.[46] For these reasons, and because the Commission intended sharing adjustments to be one-time adjustments, US West does not convince us that add-back adjustments should not be required.

40. Ameritech argues that unlike a refund that relates to a prior year, sharing is a "forward-looking adjustment of the price cap LEC's productivity target . . . ."[47] Ameritech states that given this "fact, adding back the sharing amount actually distorts and hides the relationship between productivity performance (as measured by earnings) and the new price cap target for the

---

[44] US West Comments at 7.

[45] Id. at 7-8 and 8, Table 1.

[46] See Price Cap Performance Review for Local Exchange Carriers, 9 FCC Rcd 1687 (1994) (LEC Price Cap Performance Review NPRM).

[47] Ameritech Comments at 4.

year in which the sharing took place."[48] MCI asserts that an add-back requirement is not necessary to maintain the relationship between productivity performance and rate of return because low-end adjustment "revenues are intended to recover current period costs, not prior period costs."[49]

41. Ameritech mischaracterizes the nature and purpose of the sharing mechanism. A sharing adjustment is a "forward-looking adjustment" insofar as it corrects the past in the future. That is the nature of a correction. Specifically, a sharing adjustment is made in the year after high earnings are achieved. As discussed above, however, sharing operates very much like a refund in that the obligation to make a sharing adjustment arises because of the previous year's high earnings. Moreover, both the sharing adjustment and refund occur in the year after high earnings were realized. Contrary to MCI's assertion, low-end adjustment revenues are not designed to recover current period costs. Low-end adjustment revenues arise when the LEC raises its PCI because of the previous year's low earnings to allow a LEC the opportunity to earn a higher, yet reasonable, rate of return on a prospective basis. Application of the add-back adjustment avoids erroneously treating earnings increases attributable to that low-end adjustment as an increase in productivity. That is, if other variables (e.g., expenses and investment base) were held constant and the LEC's earnings were not adjusted, the current price cap rules would regard the increase in the LEC's earnings in the following year as an increase in its productivity even though the earnings growth was solely attributable to the low-end PCI adjustment. Add-back adjustments avoid this distortion and, accordingly, ensure that the proper relationship between earnings and productivity growth is maintained.

d. An add-back adjustment is necessary to enforce earnings restrictions.

42. Ameritech asserts that the add-back mechanism is not necessary to keep earnings reasonable because "under price caps there is no maximum rate of return."[50] Contrary to Ameritech's assertion, there is a maximum allowable rate of return under the current LEC price caps scheme and the add-back mechanism is necessary to enforce that earnings restriction. A LEC choosing the 3.3 percent productivity offset is "effectively allow[ed] . . . to reach a maximum 14.25 percent rate of return[,]"[51] while a LEC choosing the 4.3 percent productivity offset "entitles itself to try to reach an effective maximum 15.25 percent rate of return."[52] An add-back mechanism is necessary to ensure that a LEC selecting the 3.3 or 4.3 percent productivity factor does not retain earnings above an effective 14.25 or 15.25 percent,

---

[48] Id.

[49] MCI Comments at 21.

[50] Ameritech Comments at 5.

[51] LEC Price Cap Order, 5 FCC Rcd 6801.

[52] Id. at 6802.

respectively, in years following a sharing adjustment. Many commenters claim that an add-back adjustment would reduce the LECs' earning potential and, therefore, dampen their efficiency incentives.[53] This adjustment, like the sharing mechanism itself, only limits the price cap LECs' earnings potential, to the extent it forces LEC earnings to fall within the range established in the LEC Price Cap Order.

43. Ameritech contends that an add-back adjustment to offset sharing "would be effectively an accounting fiction . . . . that merely distorts the actual earnings of the price cap carrier -- giving them the appearance of being higher than they really are."[54] The sharing mechanism and add-back adjustment, however, have a common purpose, assuring that LECs and their customers share fairly the rewards of annual productivity gains. The add-back adjustment does this by eliminating the effects of sharing adjustments associated with the previous year's earnings.

44. Ameritech and GTE claim that there is no basis for the concern expressed by the Commission in the NPRM that artificial swings in earnings can occur without an add-back adjustment.[55] GTE asserts that the sharing mechanism was adopted not to produce smooth earnings, but to correct for any systematic bias in the productivity offset.[56] Ameritech argues that the see-saw effect is not "objectionable" because the variations in earnings become less erratic and "stabilize[] naturally" with the passage of time.[57]

45. We are not requiring add-back adjustments to produce "smooth earnings." One collateral effect of requiring such adjustments, however, will be the elimination of any artificial swings in earnings that otherwise would arise because of sharing or low-end adjustments attributable to earlier years' earnings. The possibility that the "see-saw" effect may eventually stabilize and become less erratic does not alter our conclusion that add-back adjustments serve the public interest by assuring that sharing and low-end adjustments are one-time adjustments without ripple effects from year to year.

e. Interest included in calculating sharing adjustments must be included in an add-back adjustment.

---

[53] See Bell Atlantic Comments at 3 n.8; Pacific Comments at SWBT Comments at 2, 4; MCI Comments at 3; US West Comments at 1-2; GTE Comments at 3; USTA Comments at 4.

[54] Ameritech Comments at 5-6.

[55] Id. at 5; GTE Comments at 13.

[56] GTE Comments at 13.

[57] Ameritech Comments at 5; see also id. ("[U]nder the split tariff/sharing year situation actually faced by price cap LECs, the sharing variations are much smaller and subside more quickly.").

46. Ameritech and US West assert that if the Commission requires add-back adjustments, these adjustments should not include interest that was included in the sharing amounts.[58] In support, Ameritech and US West state that interest is designed to reimburse ratepayers for the opportunity cost of the delay in sharing the benefits of the LEC's productivity gains and that ratepayers receive the benefits of the interest amount during the period when the sharing adjustment is in effect.[59] Ameritech claims that if the interest amount is part of the add-back adjustment, "portions of this interest amount would be given back again in future sharing periods."[60]

47. Ameritech and US West appear to misunderstand the purpose behind and the goals of the sharing and add-back adjustments. The sharing mechanism returns to ratepayers their share of productivity gains plus interest through a one-time (non-permanent) reduction in the PCI.[61] We conclude that because interest is part of the sharing adjustment, failure to include interest when making an offsetting add-back adjustment would understate the amount of the actual sharing adjustment. Thus, failure to include interest in the add-back adjustment would cause sharing adjustments (to the extent of the interest amount) to be reflected in the LEC's future earnings levels, and consequently in calculations used to determine whether a LEC must make sharing and low-end adjustments in later years.[62]

f. Add-back is not a major change to the price cap plan.

48. Several commenters allege that an add-back adjustment would constitute a substantive change to (as opposed to a clarification of) the price cap rules and, therefore, cannot be applied retroactively to render existing LEC tariffs unlawful.[63] Several also assert that adoption of the add-back adjustment at this time would be inconsistent with the Commission's

---

[58] Ameritech Comments at 7; US West Reply Comments at 7.

[59] Ameritech Comments at 7.

[60] Id.

[61] LEC Price Cap Order, 5 FCC Rcd at 6801; see also id. at 6788; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2686.

[62] LEC Price Cap Order, 5 FCC Rcd at 6803.

[63] See US West Comments at 5-6 (citing Bowen v. Georgetown University Hospital, 488 U.S. 204 (1988) (Bowen)); see also BellSouth Comments at 3-9; Pacific Comments at 4; AT&T Comments at 3; GTE Reply Comments at 9-10; Bell Atlantic Reply Comments at 2; SWBT Comments at 1. Also, BellSouth asserts that because FCC Form 492 contains a line-item for an add-back adjustment and FCC Form 492A (the rate-of-return monitoring report filed by LECs subject to price cap regulation) does not, it is "clear" that an add-back adjustment would require changes to the LEC price cap rules and FCC Form 492A. BellSouth Comments at 6.

statement that it would make no "major adjustments" to the LEC price cap plan prior to the fourth-year comprehensive LEC price cap performance review.[64] They add that the add-back issue may become moot if the Commission eliminates the sharing and low-end adjustment mechanisms.

49. We agree with commenters that the explicit add-back rule adopted here may, as a legal matter, be applied only on a prospective basis.[65] Accordingly, this rule will first be applied when carriers file their 1995 access tariffs. At that point, carriers must make an adjustment to offset any sharing or low-end adjustments made for 1994 rates to determine any 1995 required sharing or permitted low-end adjustments.

50. Because add-back adjustments are necessary to achieve fully the purpose of the sharing and low-end adjustment mechanisms, we believe that adoption of this explicit rule -- even if we were to assume that the add-back adjustment is not already required under existing rules -- does not constitute a major change to the LEC price cap rules. Without this adjustment, the sharing and low-end adjustments would not operate as one-time adjustments to a single year's rates as we intended.[66]

B. Credit for Below-cap Pricing

1. NPRM Discussion of Credit for Below-cap Pricing

51. The NPRM solicited comment on whether a LEC that sets its rates below the price cap indexes during the base year[67] should receive credit for the difference between its PCI and

---

[64] See BellSouth Comments at 2, 3; Bell Atlantic Comments at 4, 5; GTE Comments at 14, 15; USTA Comments at 4; RTC Comments at 4; Pacific Comments at 4; and SWBT Comments at 1-2 (citing LEC Price Cap Order, 5 FCC Rcd at 6834 ("To provide a fair evaluation of the [LEC price cap] program, it is . . . important that the initial period before periodic review and the possibility of major adjustments be long enough for incentives to operate. We believe that a four-year period without major adjustment . . . is reasonable.")). See also Price Cap Performance Review for Local Exchange Carriers, 9 FCC Rcd 1687 (1994).

[65] See Bowen, 48 U.S. 204.

[66] While Form 492A does not contain a line to record add-back adjustments as part of the calculation of the following year's sharing and low-end adjustments, this is not dispositive of whether an add-back adjustment is required to achieve the intended effect of the LEC price cap rules. We direct the Bureau to make any changes to Form 492A necessary to ensure that Form 492A clearly indicates that the LECs must remove the effects of sharing and low-end adjustments for a given year before they calculate sharing and low-end adjustments for the following year.

[67] The base year is "[t]he 12-month period ending six months prior to the effective date of annual price cap tariffs." See Section 61.3(e) of the Commission's Rules, 47 C.F.R. § 61.3(e).

its API when it computes sharing and low-end adjustments in the following year.[68] We also requested comment on how such a credit would operate.[69] Although we reached no tentative conclusions regarding the credit issue, we stated that "in a sense, the LEC already has passed through some rate reductions by pricing below the cap [, and that a]llowing credit for below-cap rates would encourage carriers to charge lower, below-cap rates."[70] We noted, however, that if the LEC's low earnings in one year result in part from its own decision to set rates below the cap, the rationale for allowing an upward adjustment in the cap the next year seemed less compelling.[71] We noted that the 4.3 percent productivity factor already enabled LECs to trade larger up-front rate cuts for reduced sharing requirements.[72] We pointed out that the Commission explicitly declined to adopt a plan that would have automatically reduced sharing based upon the actual rates set by the LEC.[73]

2. Comments on Credit for Below-cap Pricing

52. BellSouth and Ameritech maintain that a credit for below-cap rates is appropriate because the LEC already has passed through some rate reduction by pricing below the cap, and a credit would encourage carriers to charge lower rates on a voluntary basis.[74] BellSouth and Bell Atlantic also contend that adoption of a credit would "ameliorate, to some extent, the damage done to the price cap incentive structure by the addition of an 'add-back' requirement" and would provide a positive incentive for LECs to propose lower rates.[75] US West, Bell Atlantic, and Ameritech argue that because add-back adjustments perversely affect LECs choosing to price below their caps, the Commission should "limit the 'add-back [adjustment]' to the amount that prices were actually changed as a result of a sharing or low-end adjustment."[76] As BellSouth envisions the proposed credit, carriers would calculate the amount by which they

---

[68] NPRM, 8 FCC Rcd at 4417.

[69] Id.

[70] Id.

[71] Id.

[72] Id.

[73] LEC Price Cap Order, 5 FCC Rcd at 6803.

[74] See BellSouth Comments at 10; see also Ameritech Comments at 7.

[75] BellSouth Reply Comments at 14; BellSouth Comments at 10; Bell Atlantic Comments at 7.

[76] US West Comments at 8-9; see also Ameritech Comments at 7; Bell Atlantic Comments at 7.

priced below the revenue cap in the base period and deduct that amount from the earned return calculated on the Form 492A to determine the subsequent year sharing obligation.[77]

53. NYNEX, AT&T, GTE, and MCI assert that a credit mechanism would add administrative complexity to and is inconsistent with the LEC price cap plan.[78] NYNEX and AT&T argue that a credit is unnecessary because a LEC with below-cap rates already receives a credit in the form of a smaller sharing obligation.[79] MCI claims that the below-cap credit would "allow price cap LECs to avoid sharing, in whole or in part, and thereby exceed the allowed rates of return under price cap regulation."[80]

3. Discussion of Credit for Below-cap Pricing

54. After reviewing the record in this proceeding, we find that awarding LECs a credit for setting rates below the cap during the base year period would be inconsistent with the LEC price cap plan as originally adopted. In the LEC Price Cap Order, the Commission decided to limit the LECs' choice of productivity offsets to either 3.3 or 4.3 percent. The Commission concluded that permitting the LECs to choose between these two productivity offsets gave these carriers sufficient flexibility, was relatively easy to administer and monitor, and struck a reasonable balance of interests, risks, and rewards between LECs and their customers.[81] We considered and rejected a United proposal to permit the LECs choosing to set rates at any level below the PCI in one year to have a corresponding upward adjustment to the earnings benchmarks that trigger sharing obligations. We find that awarding LECs a credit for below-cap rates is substantially similar to the rejected United proposal.

55. Allowing a LEC that has set its rates below the price cap indexes during the base year to receive credit for the amount its PCI exceeds its API in calculating sharing and low-end adjustment amounts would effectively offer the LECs productivity offset choices other than those specifically adopted by the Commission in the LEC Price Cap Order. A credit, in effect, would allow the LECs to set rates at any level below the PCI in one year and obtain a corresponding increase in the "no sharing" and "sharing zones" for purposes of calculating the next year's sharing and low-end adjustments. We, therefore, find that allowing LECs a credit for setting rates below the cap during the base year period would constitute a change in the LEC price cap

---

[77] BellSouth Comments at 10.

[78] See NYNEX Comments at 3, 13; see also AT&T Reply Comments at 6-7; AT&T Comments at 4 n.6; GTE Comments at 5, 6; MCI Reply Comments at 11-12.

[79] NYNEX Comments at 3; AT&T Reply Comments at 7.

[80] MCI Reply Comments at 11.

[81] LEC Price Cap Order, 5 FCC Rcd at 6796, 6803, 6805.

plan. Accordingly, we do not modify the LEC price cap rules to allow a credit for below-cap rates in this order.[82]

III. CONCLUDING MATTERS

A. Conclusion

56. In this order, we find that the add-back adjustment ensures that the sharing and low-end adjustment mechanisms operate as the Commission intended when it adopted the LEC price cap plan. We further find that the add-back adjustment is essential if the sharing and low-end adjustments of the LEC price cap plan are to achieve their intended purpose. Because the add-back requirement does not currently appear in our rules, we adopt the proposed revisions to the rules in order to make explicit the requirement that price cap LECs must exclude the effects of sharing and low-end adjustments relating to the prior year before computing the earnings levels that determine required sharing or permitted low-end adjustments for the current year. In addition, we direct the Common Carrier Bureau to revise Form 492A, to the extent necessary, to reflect the add-back requirement more clearly. Further, we decide not to allow a credit for below-cap rates.

B. Regulatory Flexibility Act Analysis

57. In the NPRM, we certified that the proposed rule amendment would not have a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act.[83] Neither the Chief Counsel for Advocacy of the Small Business Administration nor any commenting party disagreed with our analysis. The Secretary shall send a copy of this Report and Order, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with Section 605(b) of the Regulatory Flexibility Act, Pub. L. No. 69-354, 94 Stat. 1164, 5 U.S.C. §§ 601 et seq. (1981).

---

[82] US West asserts in its comments in this proceeding that the Commission should eliminate the sharing and low-end adjustments "in their entirety." US West Comments at 5. BellSouth and US West also urge the Commission to eliminate the price cap rule requiring a permanent reduction in a LEC's PCI when it selects a 4.3 percent productivity factor. BellSouth Comments at 11-12; US West Reply Comments at 7. These issues are beyond the scope of this proceeding and are more properly addressed as part of the LEC price cap performance review. See, generally, LEC Price Cap Performance Review NPRM, 9 FCC Rcd at paras. 43-55. We therefore decline to address these issues in this docket.

[83] NPRM, 8 FCC Rcd at 4417.